

# CONDITIONS OF COMPETITIVENESS OF CALIFORNIA'S ECONOMY













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A Monograph of the California Regional Economies Project September 2004

Prepared By Center for the Continuing Study of the California Economy

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#### **PRFFACE**

#### **Purpose: The California Regional Economies Project**

The California Regional Economies Project provides California's economic and workforce development system with information about changing regional economies and labor markets. The Project is a joint effort of the California Workforce Investment Board and the California Economic Strategy Panel. The Project was initiated in response to these challenges:

- California's economy is under-performing relative to its potential—we have tremendous talent, world-class companies, and a tradition of innovation.
- California lacks an economic and workforce investment strategy that focuses on regional strengths and opportunities, and connects state and local efforts for maximum impact.
- Local and state policymakers lack reliable and timely information about emerging industry and job opportunities, making good investment and policy decisions difficult.

The Project develops information that measures the performance of California's regional economies. This information provides a key resource in economic and workforce development planning, and a bridge connecting economic and workforce policies and programs at the state and regional levels.

Through its products and forums, The California Regional Economies Project fills a need for better information that can:

- <u>improve</u> specific decisions about state, regional, and local workforce invest ments and policies;
- <u>connect</u> state, regional, and local economic and workforce investment strategies;
- <u>focus</u> state, regional, and local marketing efforts on areas of regional economic advantage and opportunity;
- <u>inform</u> policy and investment decisions of government so that they promote, rather than discourage economic innovation and competitiveness; and,
- help individuals navigate their own transition to new employment opportunities.

#### **Phase I of the Project: Products and Forums for Users**

During 2003-4, information was compiled for each of the nine California Economic Strategy Panel regions—Northern California, Northern Sacramento Valley, Greater Sacramento, Bay Area, San Joaquin Valley, Central Sierra, Central Coast, Southern California, and the Southern Border Region (see following map).

Each of these reports was presented at a regional forum, and discussed with the regional user community (e.g., employers, workforce investment boards, local economic development organizations, local government agencies, and other interested community leaders). At each forum, users had the opportunity to discuss the findings and suggest priorities for further cluster analysis (see following chart).

In addition, the Project compiled multi-region, cross-cutting Cluster of Opportunity reports. The focus for these reports was based on recommendations from the user community at regional forums and analysis of trends in the regional data. As a result, the Project focused on industries and occupations involved in:

- Health Science and Services (across all nine regions of California)
- Manufacturing Value Chain (the value chain of design, production, and logistics sectors in the five most urban regions of the state)
- Regional Experience/Infrastructure (in the four most rural regions California)

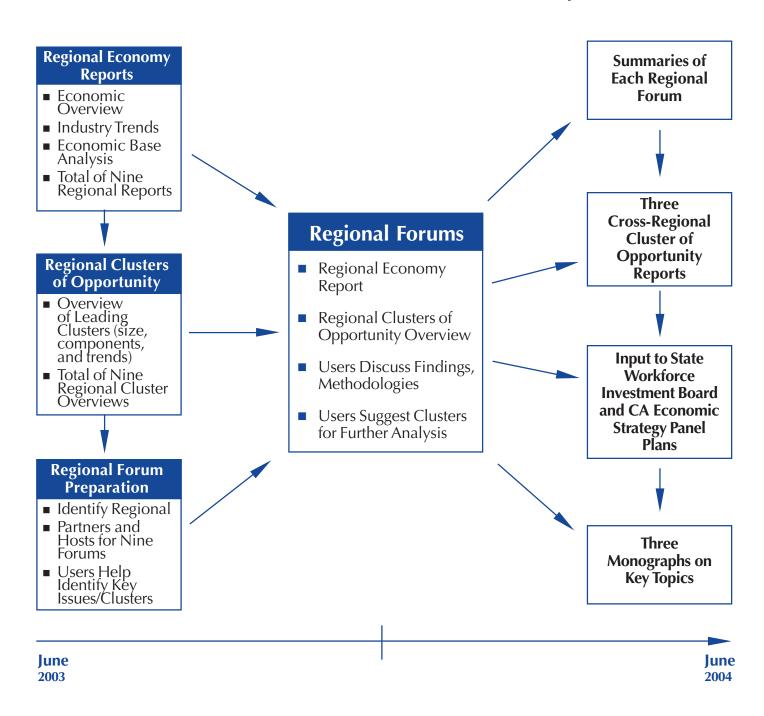
Each region was examined as part of the clusters of opportunity shown below.

Regions	Health Science And Services	Manufacturing Value	Chain RegionalExp/Infra
Northern California	XX		XX
Northern Sacramento Valley	XX		XX
Greater Sacramento	XX	XX	
Bay Area	XX	XX	
San Joaquin Valley	XX	XX	
Central Sierra	XX		XX
Central Coast	XX		XX
Southern California	XX	XX	
Southern Border	XX	XX	

## **THE PROJECT REGIONS**



## CALIFORNIA REGIONAL ECONOMIES PROJECT



The Project also produced monographs focused on key policy areas of concern to the regional user community and state-level policymakers. Theses monographs are focused on:

- The Conditions of Competitiveness of California's Economy. This monograph provides a balanced look at California's business climate by examining both cost and productivity factors with a special focus on the role of talent.
- Innovation, Productivity and California's Prosperity. This monograph examines the role of innovation in changing industry clusters, the impact of innovation and technology on productivity as well as the impact of productivity on the dynamics of job change.
- Creating a Workforce Transition System in California: Based on the regional analysis, this monograph recommends how a workforce transition system could be designed to help workers make transitions both within industries through career progression from entry to mid and higher occupational levels as well as transition across industries through adjustment to structural economic changes.

The monographs reinforce findings from the cluster reports as well—namely the importance of a balanced business climate based on cost and productivity, the imperative of innovation across all industries, and the need for a more effective workforce transition system to support California employers in their drive to innovate and remain competitive in the global economy.

#### **Project Team and Sponsors**

The Project Team includes Collaborative Economics (<a href="www.coecon.com">www.coecon.com</a>), Center for the Continuing Study of the California Economy, (<a href="www.coecon.com">www.coecon.com</a>), California Center for Regional Leadership (<a href="www.calregions.org">www.calregions.org</a>), and J.K., Inc.

The *California Workforce Investment Board* was established in 1998 to provide strategic guidance to the state's workforce investment system. For more information, visit <a href="http://www.calwia.org">http://www.calwia.org</a>.

The bipartisan *California Economic Strategy Panel* was established in 1993 to develop a statewide vision and strategy to guide public policy decisions for economic growth and competitiveness. For more information visit <a href="https://www.labor.ca.gov">www.labor.ca.gov</a>.

#### **EXECUTIVE SUMMARY**

- The qualities that make a regional and state economy attractive for basic industry job growth are the focus of this monograph. Private sector investment and job growth are the key determinants of opportunities from broad-based economic prosperity throughout California's regions and the conditions for attracting private sector investment and job growth are of interest to all participants in developing state economic policy.
- The advice that "one size does not fit all" applies to determining how to increase California's competitive edge. A detailed list of the state's basic industries (see Appendix A) confirms the diversity of California's leading industries. When the diversity of the state's economic base is combined with the difference between policies to retain companies compared to policies to attract the creation of new companies, it is clear that policies to increase the state's competitive edge must themselves be diverse.
- Governors and legislatures do not create recessions nor do they have the tools to end recessions. Moreover, state governments do not have tools to affect short-term industry trends or the stock market. The desire of state elected officials to help residents overcome layoffs and unemployment is not matched by any effective means of doing so.
- Reducing the negatives and increasing the positives are the two major strategies that
  have emerged in the long discussion about California's "business climate" and how to
  increase the state's competitive edge in retaining and attracting private investment.
- Cost factors are one determinant of location choices and, thus, are critical to any discussion of competitive edge in relation to attracting and retaining private investment. Cost factors can be direct money costs including taxes, fees, energy and insurance costs and can also be indirect costs including the impact of regulations and the impact of housing costs.
- In addition to controlling business costs, increasing California's competitive edge depends on providing a high quality of life or, in other words, great places to live and work. State economic policy, including state budget policy, plays a critical role in the broad quality of life issues that affect California's competitive edge.
  - 1) *Public investments* lay the foundation for competing to attract *private investments*. Investments in education and infrastructure are examples of public investments that help attract private capital to California.
  - 2) California has always had a competitive edge in many quality of life areas from climate to culture, recreational opportunities, open spaces and a tolerance for diverse life styles that has helped attract talented people in many industries.

Today, both the state's public investment agenda and the ability of local communities to offer great places to live and work are threatened by a variety of factors including budget challenges.

- There is broad agreement among business leadership organizations that increased public investment and quality of life are significant components of any strategy to increase California's competitive edge.
- However, there are two "big picture" conflicts in coming to consensus on policies to increase California's competitive edge.
  - 1) The first dilemma is that not all businesses are attracted by the same factors. For example, high-tech startups may care more about the educational system, infrastructure and quality of life, while paint manufacturers may care more about energy costs and taxes. So, in part, what makes a good business climate and what the state should do depends on what kind of industry you want to attract and grow.
  - 2) The second dilemma is that policies for the state in supporting and attracting private investment sometimes point in different directions. Investing more in education and infrastructure and creating great places to live and work may require more public funding than is currently being spent, while lowering tax rates or granting tax incentives for business will reduce the funds available for public services and public investment.
- The search for public policies that support the creation of new private investment and associated jobs is caught in the same set of choices that have paralyzed the state's budget process. Do Californians think the way to attract business is to support spending for education, infrastructure and local governments, which will probably require an increase in public revenues? Or, is the best approach for attracting private investment to reduce the level of public services in an effort to balance the budget without raising taxes? Or is there a third way, which will allow the state to invest more without raising taxes or fees?

#### I. Introduction

This monograph was prepared as part of the Regional Economies Project sponsored by the California Workforce Investment Board and the California Economic Strategy Panel. The economic base of each of California's nine economic regions was analyzed as part of the project work and presentations were made in each of the nine regions.

This monograph is one of three monographs prepared to expand on some of the major policy related questions and issues that arose during the first year analyses and presentations of the Regional Economies Project.

#### The Twin Challenges of Economic Growth and Workforce Investment

The California Regional Economies Project responds to two separate sets of regional priorities. Many regional organizations are focused on efforts to promote long-term economic growth that is broadly shared among each region's residents. The project's economic base analyses will help to identify sectors that have the potential for high-wage job growth such as, for example, biotech. The project will select specific industry clusters for deeper analysis. One aspect of the cluster analyses is to identify workforce policies that will support cluster growth.

Workforce boards play a role in promoting economic growth but they also have mandates to help residents train for and find jobs when they are unemployed. Workforce boards are moving beyond the traditional job-finding role to develop programs focused on career paths and upward mobility.

Many areas of workforce shortage are not in the center of a region's economic base. They are in the many population-serving sectors like health care, construction and education. So, this project will focus also on the size of sectors, not just their potential for rapid growth, and look closely at population-serving activities as well as each region's economic base.

### The Twin Challenges of Economic Growth and Workforce Investment

#### **Economic Growth**

- Identify sectors for innovation and growth, for example, biotech and nanotech
- Identify workforce and other policies to support high growth sectors
- Focus primarily on the region's economic base

#### **Workforce Investment**

- Identify sectors where people can find career paths and upward mobility, for example, nursing and construction
- Identify workforce policies that support both individuals and sectors
- Focus significantly on population-serving sectors

#### **Focus on Conditions of Competitiveness in California's Economic Base**

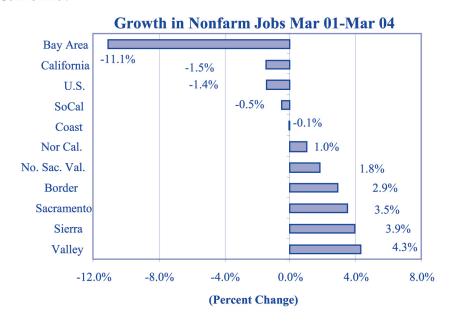
The economic base in California's regional economies includes the industries that sell a large portion of goods and services to customers located outside of each region. They are "export" industries and these industries generally have a choice of where to locate facilities. Thus economic regions "compete" for the attraction and retention of basic industry jobs.

The qualities that make a regional and state economy attractive for basic industry job growth are the focus of this monograph. Private sector investment and job growth are the key determinants of opportunities from broad-based economic prosperity throughout California's regions. The conditions for attracting private sector investment and job growth are of interest to all participants in developing state economic policy.

#### A Brief Update on Recent Job Growth Trends

For the three-year period from March 2001 (the beginning of the national recession) through March 2004, the nation lost 1.9 million jobs or 1.4% of the pre-recession job level. California's job loss was slightly higher at 1.5% according to revised data released in May 2004 by the California Employment Development Department.

During this period, a few states including Florida and Nevada posted job gains, while many states including Massachusetts, Colorado and North Carolina experienced job losses greater than those in California.



California's job losses were concentrated in one region—the San Francisco Bay Area. Eight of the state's nine economic regions outpaced the nation in job performance and six regions added jobs during the past three years.

As in the early 90s economic downturn, the job losses were concentrated in one or two industry sectors and in one region of the state. This finding confirms the importance of analyzing the state economy in terms of regions and industries.

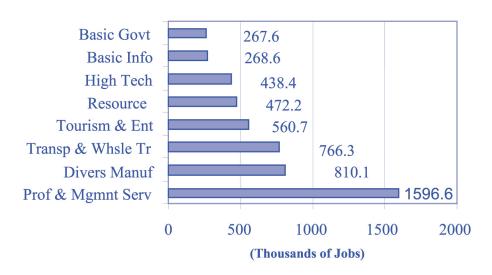
#### California's Economic Base—Some Basic Data and Trends

California's economic base was disaggregated into eight major categories for purposes of providing a summary of key trends in each region:

High Tech Manufacturing
Diversified Manufacturing
Wholesale Trade and Transportation
Professional, Technical, Scientific and Management Services
Basic Information Services
Entertainment and Tourism
Basic Government Services (Federal and State Government)
Resource Based

In 2003, approximately 5.2 million of the state's 16.1 million jobs (32%) were in California's economic base. Professional, technical, scientific and management services is the state's largest basic industry category with 1.6 million jobs in 2003.

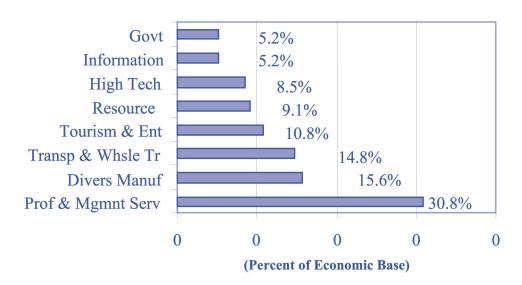
#### California Economic Base in 2003



Diversified manufacturing is the second largest basic industry category with 810,100 jobs followed by transportation and wholesale trade (766,300 jobs) and tourism and entertainment with 560,700 jobs.

Professional, technical, scientific and management services accounted for 30.8% of all basic industry jobs in California in 2003. Diversified manufacturing accounted for 15.6% followed by transportation and wholesale trade with 14.8%. High tech, resource based industries and tourism and entertainment each had approximately 10% of basic jobs while basic information and basic government each accounted for approximately 5% of California's economic base.





California's share of the nation's basic industry jobs is shown below.

California Share of U.S. Economic Base

12.6%

12.4%

12.2%

12.0%

11.6%

11.6%

11.2%

11.0%

11.0%

California's share of basic industry jobs fell from 12.5% in 1990 to 11.6% in 1994 reflecting both the loss of defense-related jobs and the decline in the state's share of jobs in aerospace. The state's share rose back to 12.5% by 2000, reflecting share gains in diversified manufacturing, information and professional, technical, scientific and management services.

California's share of basic industry jobs fell again after 2000 but the share loss in the current downturn was only 0.1% as compared with the 0.9% share drop in the early 90s recession.

#### The Diversity of California's Economic Base

The advice that "one size does not fit all" applies to determining how to increase California's competitive edge. A detailed list of the state's basic industries (see Appendix A) confirms the diversity of California's leading industries. When the diversity of the state's economic base is combined with the difference between policies to **retain** companies compared to policies to **attract** the creation of new companies, it is clear that policies to increase the state's competitive edge must themselves be diverse.

California's manufacturing base ranges from semiconductors to cut and sew apparel, from aerospace to furniture, from medical equipment to plastics and chemicals and from pharmaceuticals to paper.

Outside of manufacturing the state's economic base has strength in professional services and information. Specific industries range from scientific R&D services to telecommunications, from computer services to architectural and engineering services and from management, scientific and technical consulting to software publishing and Internet services.

California also has major job concentrations related to foreign trade, tourism and entertainment and agriculture. Specific industries range from wholesale trade to motion pictures and from accommodations to agriculture and amusements.

New national job growth projections confirm that California's economic base is concentrated in areas with above-average growth prospects. Foreign trade is a leading growth sector. Professional services and information services have above-average job growth prospects. Entertainment and tourism have above-average job growth prospects.

California's basic industry growth is helped significantly by the formation of new firms. The state regularly captures more than 40% of new venture capital funding and a recent PPIC study showed that most of Silicon Valley's job growth in the 1990s came from new firms, not from firms in existence in 1990.

# II. State Economic Policy is Most Effective When Oriented to the Long-Term

Governors and legislatures do not create recessions nor do they have the tools to end recessions. Moreover, state governments do not have tools to affect short-term industry trends or the stock market. The desire of state elected officials to help residents overcome layoffs and unemployment is not matched by any effective means of doing so.

Governor Wilson did not create the national recession of the early 90s, did not cause the simultaneous aerospace downturn and did not make the recession last longer in California than in the nation. Similarly, Governors Davis and Schwarzenegger did not create the national recession of 2001, did not create the international tech downturn, did not cause the stock market drop and did not cause the current national "job recovery" to be the weakest since the Great Depression.

California job growth has followed the nation into and out of recession over many decades and through Republican and Democratic administrations in Washington and Sacramento. The state has outpaced the nation during long periods of economic growth but has not moved in a different direction from the nation except during the early 90s.



#### **Why States Can't Fight Recessions**

Recessions are caused by a drop in total spending. The federal government has three primary tools to stimulate total spending and help lower unemployment:

- 1) The Federal Reserve Bank lowers interest rates to make borrowing and spending less expensive. Consumers benefit from lower interest payments. For example, in the current downturn, interest rate cuts have allowed many homeowners to refinance and reduce their monthly payments. In addition, interest rates cuts are supposed to provide an incentive to businesses to invest.
- 2) Congress reduces tax rates temporarily to increase the cash available to consumers to spend.
- 3) Congress can increase the level of government spending, for example, through spending on defense and non-defense purchases or by increased grants to state and local governments that act to prevent cuts and layoffs at the state and local level.

The reason that temporary tax cuts and increased federal spending work in fighting recessions is that the federal government can spend more than it takes in as a tool in fighting recessions. That is, the federal government can run a deficit and it is this deficit that provides the extra stimulus to total spending.

There are two major reasons why state governments are ineffective at fighting recessions:

- 1) State budgets must be balanced. If states were to increase spending as the federal government is doing, they would be required to raise revenues, which would negate the stimulus effect. Similarly, tax cuts would need to be balanced with spending cuts, again providing no net boost to spending.
- 2) State governments do not possess broad economy-wide powers. States do not control interest rates, nor do state budgets (even if deficits were allowed) have enough scope to boost **national spending levels.**

As much as Governors want to help residents caught up in job loss and tough times, the tools available to Governors give them a significant economic role, but it is in building long-term foundations to attract private sector investment, not in fighting today's recession.

Increasing the Positives, Reducing the Negatives—Building California's Competitive Edge

Two major strategies have emerged in the long discussion about California's "business climate" and how to increase the state's competitive edge in retaining and attracting private investment.

#### Reduce the Negatives

Cost factors are one determinant of location choices and, thus, are critical to any discussion of competitive edge in relation to attracting and retaining private investment. Cost factors can be direct money costs including taxes, fees, energy and insurance costs and can also be indirect costs including the impact of regulations and the impact of housing costs.

#### Workers' Compensation Costs

One strategy focuses on "reducing the negatives" so that state policy may create on California's competitive edge. The poster child in the "reduce the negatives" strategy is workers' compensation costs. A broad consensus developed that 1) California's workers' compensation costs greatly exceeded the national average and 2) that much of the higher than average costs was attributable to parts of the system that should be reformed.

As a result, two sets of substantial reforms have been adopted, one in 2003 and one in April 2004 after Governor Schwarzenegger made reform a central priority. Some rate reductions are expected shortly and an additional set of reductions is hoped for early in 2005.

For the moment, the focus has switched from adopting reforms to how the reforms will be implemented and whether the anticipated cost savings will occur **and** whether cost savings will be passed on to businesses in the from of rate reductions. One "plus" of the workers' compensation reforms is the positive impact on government budgets, as the cost savings will accrue also to public agency workers' compensation programs.

#### **Energy Costs**

Many energy costs, including electricity and gasoline, are higher in California compared to the national average and to the energy costs in many other states. California has had one experience with "energy reform" and Governor Schwarzengger has identified energy reform as an area for his near-term focus.

It is likely that energy costs in California will remain above the national level even if the state can find a more effective policy mix. Gasoline costs are higher as a result of environmental standards that have broad support and environmental regulations and the resource mix available to California consumers, in part, determine electricity costs.

The long-term contracts signed during the recent energy system turmoil account for an additional part of current high energy costs. The final accounting on these costs is not completed yet as court cases continue and new evidence of market manipulation is revealed.

Still, it is likely that market-based reforms can improve the reliability and cost situation for California energy consumers. For example, there is broad support among energy policy analysts for the idea of varying electricity prices by time of day as a way to bring more fairness into the system (by having peak users pay more) and to reduce peak usage

Another proposal being debated currently would allow business users to buy power wherever they wished and bypass the major utility providers if they wished. The idea is that this competition might bring forth new energy sources and reduce energy costs for users.

This proposal raises equity issues that are found in many "cost reduction" proposals being espoused. Governor Schwarzenegger and other proponents of allowing companies to buy power in the open market have pledged that residential and small business customers will not be financially harmed if larger companies stop buying from the state's major private and public utility organizations. The "hold harmless" pledge seems to imply a transfer of money to compensate utility companies for their prior capital investments. Until these compensation arrangements are spelled out, it is not possible to determine if the proposal confers **general** or **limited** benefits.

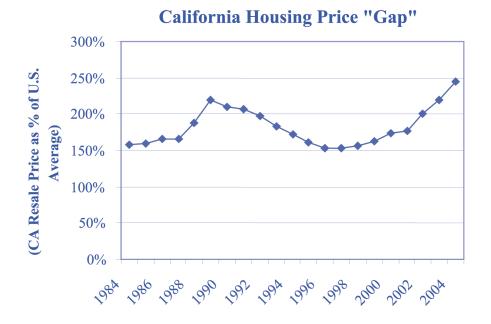
Both past and current energy reform discussions face the challenge of bringing flexibility and lower costs to energy production (including, if possible, lower regulatory costs) without sacrificing environmental or equity goals.

Finally, energy is an excellent example of the doctrine that "one size does not fit all". **The importance of energy costs in varies significantly by industry**. Energy costs are a significant cost factor for some manufacturing industries. But energy costs are less likely to be a critical factor for many sectors in the state's economic base including professional services, information services, foreign trade and entertainment and tourism.

#### **Housing Costs**

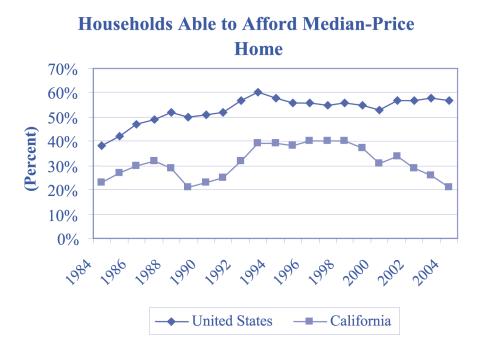
Housing costs are regularly cited as one of the cost factors that diminish California's competitive edge. The California Business, Transportation and Housing Secretary Sunne Wright McPeak has spoken eloquently about the negative impacts that high housing costs create for the attraction of private investment while President of the Bay Area Council and in her new role as Secretary. This concern is echoed in all recent "business climate" studies about California.

Recent statistics support the concern about housing costs. California is rapidly losing ground on major measures of housing affordability. The median price of existing homes in California was  $2 \frac{1}{2}$  times the national average in March 2004, the highest gap on record and above the previous record in 1989 before the economic and housing market collapse in California.



California median prices moved toward the national average in the early and mid 1990s before a series of double-digit price gains in recent years. Moreover, the housing price gap has moved from the Bay Area to most other regional markets throughout the state. For example, median prices in the Inland Empire and Sacramento are now \$100,000 above the national average and median prices in San Diego and Orange County are near those in the Bay Area.

The flip side of high housing costs is low affordability. The problem for California's competitive edge is twofold—1) low absolute affordability levels and 2) the largest statenational affordability gap on record.



Just 21% of California households could afford the median-priced home in March 2004. The 21% figure matches the record low from 1989. But, while affordability has returned to 1989 lows in California, affordability has risen in the Untied States. As a result, the affordability gap between the state and nation reached a record high in March 2004.

As the housing price competitive situation gets worse, solutions are still mostly in the discussion stage. Nearly all housing will be built by the private sector. So, the goal of state policy is to facilitate private sector housing construction consistent with environmental goals. The problems impeding housing construction are well documented and include state policies, local policies, consumer preferences and NIMBYism:

- —State fiscal policies after Proposition 13 have not provided sufficient fiscal incentives for cities to approve many housing projects. Current residents often face service level cuts as a result of new housing.
- —State fiscal policies still give cities incentives to compete against each other for new commercial activity in contrast to increasing the regional stock of housing or industrial building.
- —Residents have not come to agreement on the type and mix of housing that meets consumer preferences and overall housing construction goals. Aging and changing consumer preferences in favor of denser urban and suburban living will help in the decade ahead but housing still must meet the market test of what buyers will purchase.
- —Despite social pressures, the reasons for NIMBYism remain. People have trouble seeing the regional implications of their local decisions to deny housing. It is easy to imagine that housing will be built elsewhere and that one's decision to deny housing locally will not affect regional job growth or that regional job growth does not matter. And, there **are** negative local impacts of housing, particularly in a world where all local governments are short of funds to mitigate negative impacts.

Housing costs are a broader negative competitive factor than energy because the impacts affect many more industries. Housing costs not only affect investment decisions directly because firms must pay more to offset housing costs, there are indirect effects as well. High housing costs become a quality of life issue as low and middle-wage workers struggle to live near their jobs or remain in the region.

So, high housing costs relative to other states affects the ability of "nurses, teachers and public safety employees" to find housing and, thus, may diminish the quality of life offered by California regions.

#### Other Cost Factors

There is a long list of cost factors mentioned in recent "business climate" reports. Most of these, unfortunately, do not have the broad agreement that underlay the search for solutions for workers' compensation costs or the search for efficient practices that underlies the best in energy reform thinking. Mostly, they appear to be fights over money.

Repeal of family leave benefits or repeal of new health insurance benefits under SB2 poses direct monetary conflicts between workers and companies. Most tort reform debates, similarly, are about monetary interest conflicts between parties. It is beyond the scope of this project to offer an opinion on who is "right" but disagreements about equity block the kind of agreement that finally emerged about workers' compensation.

Some "cost" factors may increase California's competitive edge. For example, it could be argued that paid family leave (principally paid by employees themselves) could be attractive to the kind of highly skilled workers California is trying to attract and clean air, in part the result of the state's environmental regulations, is also a positive quality of life factor in competing for jobs.

Unemployment insurance costs pose a different challenge from workers' compensation because, in part, today's problem arises both because employer costs and worker benefit levels were very low in the boom years. Prior to 2001, California was a low benefit, low tax state relative to unemployment insurance. Then benefit levels were raised toward the national level at the same time the economy turned down and the taxable wage base was at the lowest legal level. The goal here is to find a set of changes that bring self-sufficiency to the fund and more stability to employer premium rates.

The Legislative Analyst's Office reported that in the fourth quarter of 2003, average weekly unemployment insurance benefits were \$251 in California, \$259 in Texas, \$261 in the nation and even higher in many large states including New York, New Jersey, Pennsylvania, Michigan and Illinois. Benefit increases scheduled for 2004 and 2005 will probably push the state average benefit level above the national average.

On the other hand, only Florida and California among large states have a taxable wage base of \$7,000. Other states have higher taxable wage bases.

#### Increasing the Positives

California's economic base is filled with companies and industries that are at the cutting edge of innovation and creativity worldwide. California's future economic success depends on attracting and retaining these companies and industries. Whether in computing hardware or computer animation, in semiconductor equipment design or apparel or furniture or auto design, in writing computer code or movie scripts, California's economy depends on attracting the "best and the brightest".

In addition to controlling business costs, increasing California's competitive edge depends on providing a high quality of life or, in other words, great places to live and work.

State economic policy, including state budget policy, plays a critical role in the broad quality of life issues that affect California's competitive edge. One, public investments lay the foundation for competing to attract private investments. Investments in education and infrastructure are examples of public investments that help attract private capital to California.

Two, California has always had a competitive edge in many quality of life areas from climate to culture, recreational opportunities, open spaces and a tolerance for diverse life styles that has helped attract talented people in many industries.

Today, both the state's public investment agenda and the ability of local communities to offer great places to live and work are threatened by a variety of factors including budget challenges.

There is broad agreement among business leadership organizations that increased public investment and quality of life are significant components of any strategy to increase California's competitive edge. As illustrated below, business organizations are usually in a leadership role in terms of raising money for investment and quality of life initiatives.

#### K-12 Education

A world class K-12 education system supports California's competitive edge in two ways. First, a good K-12 education is a prerequisite for a well-educated workforce. Second, good schools are a prerequisite for attracting talented people to come and live in California. Creative entrepreneurs and workers expect to have good schools for their children.

The California Business Roundtable website says, "According to the Eleventh Annual Business Climate Survey, the shortage of qualified workers is the most significant cost driver for California businesses. The business community understands that education is the key to building a prosperous California. That explains why California business leaders cited improving the quality of K-12 public education as the most important policy priority for California's future growth."

There is broad agreement that money is not the only consideration in evaluating a school system. There is broad agreement that educational system reforms including directing funds where they are most needed are critical. But there is also broad agreement that funding in California is well below where we want it to be and that funding levels do matter.

The basic facts are well known. California ranked 30<sup>th</sup> among states in per pupil funding in 2002-2003. Per pupil spending in California was \$7,244 compared to \$7,829 in the nation. Per pupil spending would need to have been \$9,232 to place California at the bottom of the top 25% of all states.

California would need to add \$13 billion per year to K-12 funding to be in the top 25% nationally. Per pupil funding has been below the national average in every year since the passage of Proposition 13.



K-12 Per Pupil Spending as % of U.S.

California is a high wage state generally and California's teachers are the highest paid in the nation with average salaries of \$56,283 compared to the national average of \$45,930. Below average funding and above average salaries result in the third highest class sizes among all states.

State and regional business leadership organizations including the California Business Roundtable, the Bay Area Council and Los Angeles and San Diego Economic Development Corporations have been constant voices for the idea that improving California's K-12 education system is an important business competitive concern.

Currently, a Silicon Valley business leadership organization, the Silicon Valley Manufacturing Group, is supporting the campaign to approve a parcel tax throughout Santa Clara County to increase funding for K-12 education. And, more than 70% of recent school bonds have been approved, most with strong business support.

#### **Higher Education**

California's public universities and community colleges support the state economy in two principal ways. First, California's public colleges and universities from U.C., Berkeley to San Jose State to L.A. Trade-Technical Community College provide specialized education and training that meets the needs of California industries. Moreover, California's major research universities have supported the creation of thousands of companies to turn research and development findings into new goods and services.

Second, these colleges and universities are part of California's "quality of life." Most California college students attend a public college or university in California. The strong reputation of California's decades old commitment to higher education and to the ability of all eligible students to gain admission to and get financial support to attend these schools gives California a competitive edge in attracting entrepreneurs and workers and their families.

The nine regional meetings conducted in this California Regional Economies Project have provided testimony to the importance of higher education as a competitive edge, but also as a challenge for the state. Governor Schwarzenegger acknowledged that higher education supports the economy in the statement accompanying his budget proposals for higher education.

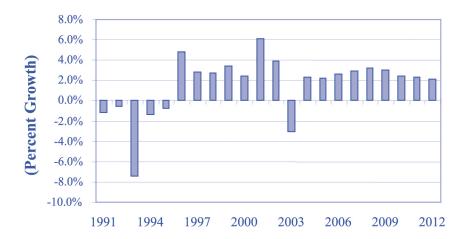
One story, repeated in several of the nine regional forums, illustrates the opportunities and challenges. Health care was identified as an area of current and future job growth in all nine regions. Industry panelists identified nursing as an area with current and projected staffing shortages. California's four-year colleges **and** the state's community colleges have programs that train nurses.

But there are many challenges. Community college representatives told of admission backlogs, sometimes reaching two-year waits, in their nursing programs. Moreover, key course offerings, like anatomy and physiology, are overbooked and eligible students cannot all find the classes they need. In addition, nursing programs cost more per student than other programs such as English and community colleges are normally funded on a per pupil basis without regard to program cost.

The inability to train enough nurses hurts the economy in two major areas. First, nursing shortages hurt the health care industry's ability to provide first-class services just as shortages of other types of key workers such as engineers hurt the ability of companies to compete. But there is also a quality of life affect as in education. Communities with sub-par health care or sub-par schools will be less attractive as places to live and work.

Three long-term challenges face California's public higher education system. One is rapidly growing enrollment, what has been referred to as Tidal Wave II. Enrollment is expected to increase by at least 25% in the next decade as the children of baby boomers reach college age.

#### **California Higher Education Enrollment**



The second challenge is increasing the college-going rates for the children of immigrants and of minority children in general. California's workforce will increasingly depend on the children and grandchildren of immigrants and for many of these students going to college will be a first for their families. Public policies play a role in encouraging college attendance and making it affordable.

The third challenge is affordability. In a period when tuition is rising rapidly, partly as a result of state fee policies, it is especially challenging to have student grant and loan money keep up with the rising demands for these funds.

#### <u>Transportation and Other Infrastructure Investment</u>

There is broad agreement that transportation and other infrastructure investment support California's competitive edge. Regional business groups regularly lead the efforts for local transportation-related sales taxes and bonds. Governor Schwarzenegger, in announcing a partial rescinding of planned transportation investment reductions, cited the importance of transportation investments for California's economy.

Transportation investments build capacity to support increases in foreign trade, one of the major sectors in California's economic base. Transportation investments build capacity to handle more daily traffic for people and goods. And transportation investments help reduce costs by maintaining the facilities built in previous generations.

An April 2004 report from The Transportation Information Program listed six California areas—Los Angeles, San Jose, San Francisco-Oakland, San Diego, Sacramento and Riverside-San Bernardino— among the top eight nationally for the highest percentage of roads in poor condition. The study estimates that poor roads cost the average motorist \$400 annually for additional vehicle operating costs.

Other data underscore the serious deficiencies in California's transportation infrastructure. The Legislative Analyst's Office reports that as vehicle miles traveled are increasing, real spending for road maintenance is falling. A California Transportation Commission study found more than \$100 billion in needed state investment. The just-released SCAG Regional Transportation Plan identified more than \$120 billion in needed regional transportation investment with a major portion for which no funding is available.

And, in an interview published in the Sacramento Bee on May 29, 2004, Governor Schwarzenegger characterized California as "way behind" in infrastructure investment.

Money is not the only challenge. Southern California and San Diego are both struggling with how to provide sufficient airport capacity when airports are needed regionally but unpopular as neighbors in most communities. Some capacity additions may be funded privately as with the proposed separated or dedicated truck lanes in the SCAG plan but require changes to federal or state law. And there are many innovative market-based approaches to maximizing the use of existing capacity.

#### Great Places to Live and Work

For decades, California communities were recognized as great places to live and work. A great climate, excellent recreational facilities, access to both mountains and oceans, good local parks and public facilities and steady improvements in air and water quality helped California rank at or near the top in polls asking "where would you like to live".

These attributes, together with sufficient housing, good schools and adequate infrastructure, constitute the main elements of "a high quality of life". And a high quality of life is one of California's major "competitive" forces in attracting new entrepreneurs and innovations. When you can locate a business anywhere, why would you locate in a place that was not attractive for living as well as working?

The Governor and Legislature have a significant role in developing public policies that affect the quality of life in California communities. Both the state budget and state-local fiscal relationships, including Proposition 13, heavily influence local government funding and land use choices.

State-local fiscal relationships and the incentives produced by the current system have proven difficult to improve, but there is no question that these choices affect California's competitive edge.

# III. Conflict or Consensus—Are Any Choices Clearly Right?

There are two "big picture" conflicts in coming to consensus on policies to increase California's competitive edge.

The first dilemma is that not all businesses are attracted by the same factors. For example, high-tech startups may care more about the educational system, infrastructure and quality of life, while paint manufacturers may care more about energy costs and taxes.

So, in part, what makes a good business climate and what the state should do depends on what kind of industry you want to attract.

The second dilemma is that policies for the state in supporting and attracting private investment **sometimes point in different directions.** Investing more in education and infrastructure and creating great places to live and work may require more public funding than is currently being spent, while lowering tax rates or granting tax incentives for business will reduce the funds available for public services and public investment.

The search for public policies that support the creation of new private investment and associated jobs is caught in the same set of choices that have paralyzed the state's budget process. Do Californians think the way to attract business is to support spending for education, infrastructure and local governments, which will probably require an increase in public revenues? Or, is the best approach for attracting private investment to reduce the level of public services in an effort to balance the budget without raising taxes? Or is there a third way, which will allow the state to invest more without raising taxes or fees?

